

*United States Court of Appeals
for the Second Circuit*



**PETITION FOR
REHEARING
EN BANC**

75-7503

United States Court of Appeals FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM,

Plaintiff-Appellant,

—against—

ROBERT G. ZELLER, *et al.*,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING OR, ALTERNATIVELY, SUGGESTION FOR REHEARING IN BANC

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April 1, 1977



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Defendants-Appellees F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc. ("M&D") and Robert G. Zeller petition the Court for rehearing or, in the alternative, suggest rehearing in banc of the decision of a panel of this Court rendered March 4, 1977 (Lumbard and Timbers, *Circuit Judges*, and Bryan, *District Judge*). The time for filing this petition was extended to April 1, 1977.

The panel held in a shareholder's derivative suit brought on behalf of a mutual fund, as did the District Court after trial (Carter, J.), that the board of directors of the Fund, consisting of independent "men of repute in business and the professions" (slip op. 6279), made in good faith a

reasonable and fully informed business judgment that the Fund should *not* seek the "recapture" of brokerage commissions.

Nevertheless the panel reversed a judgment dismissing the complaint *on a theory which was neither tried nor properly raised in the District Court*. The panel held that the proxy statements of the Fund for the years 1967 through 1971 were false and misleading for failing to disclose the possibility of recapture which an independent board of directors had properly rejected in the independent exercise of business judgment as not in the best interests of the Fund.

I.

The panel's holding with respect to the Fund's proxy statements is egregiously erroneous and spells disaster for the mutual fund industry.

The panel's decision that the Fund's proxy materials were false and misleading is so aberrational that no precedent is or can be cited to support it. Never before, so far as we know, has a federal court held that a corporation is required to detail in proxy statements business alternatives which an independent board of directors has properly rejected as not in the best interests of the corporation.

The error and exceptional importance of the panel's decision cannot be deemed limited by the panel's observation that in the mutual fund industry, "self dealing . . . is the order of the day" (slip op. 6268, 6329). Boards of directors in every line of business are frequently compelled to make business decisions which involve conflicts of interest; if the panel is correct, the existence of a conflict of interest involving corporate management would require the dis-

closure of rejected business alternatives even if the rejection was made, as it was in this case, by disinterested directors who acted reasonably and properly.

For the mutual fund industry, the panel's decision spells disaster. The panel said that the Fund's false and misleading proxy statements over a five-year period "rendered ineffectual the shareholders' approval of the management agreements" between the Fund and its investment adviser (slip op. 6330). In two of those years, 1970 and 1971, the Fund shareholders approved new management contracts pursuant to which the adviser received compensation of approximately \$3.9 million (slip op. 6278-9, fn. 7).

Even though the District Court found that this rate of compensation was less than the industry average and that the investment adviser rendered superior services (App. 77),* plaintiff can be expected to contend on remand that by reason of Section 47(b) of the Investment Company Act, which denounces as "void" every contract made in violation of the Act or of any rule or regulation thereunder,** she

* The Joint Appendix on appeal is hereinafter referred to as "App."

** Section 47(b) of the Act, 15 U.S.C. § 80a-46(b), provides as follows:

"Validity of contracts.

"(b) Every contract made in violation of any provision of this title or of any rule, regulation, or order thereunder, and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, regulation, or order."

can recover for the Fund the entire management fee paid in 1970 and 1971. This bonanza would be far more than plaintiff could have recovered had she prevailed on the ~~not~~ issue which was tried in the District Court—the Fund's failure to seek recapture of brokerage commissions.

As the panel's opinion makes clear, the availability of recapture was not unique to Chemical Fund. Most of the larger mutual funds in the industry have rejected recapture, except for those few which distribute their shares through captive sales forces rather than through independent securities dealers and hence have no occasion to allocate brokerage business to dealers who sell fund shares (slip op. 6272, fn. 4) and except for those which adopted recapture techniques in order to settle litigation such as this.* Almost without exception, none of these funds disclosed in its proxy materials that recapture was available but had been rejected.

If the panel's decision stands, most mutual fund proxy statements in recent years will be deemed false and misleading, most mutual fund management contracts are in limbo and mutual fund managers and directors stand exposed to huge judgments for failure to make proxy statement disclosures which no one, including the Securities and Exchange Commission, has ever considered necessary or appropriate.

In view of this Court's observation that mutual funds are "freighted" with conflicts of interests, *Galfand v. Chestnut*, 545 F.2d 807, 808 (2d Cir. 1976), the panel's decision would require that almost every important business decision made by a fund's board of directors be followed by proxy

* See, e.g., *Weiss v. Chatter*, 59 F.R.D. 533, 535 (S.D.N.Y. 1973); *White v. Auerbach*, CCH Fed. Sec. L. Rep. ¶ 93,617, at p. 92,827 (S.D.N.Y. 1972); *Schlusselberg v. Keystone Custodian Funds, Inc.*, CCH Fed. Sec. L. Rep. ¶ 93,901 (S.D.N.Y. 1973).

statement disclosure of rejected alternatives. Since any business decision necessarily embodies the rejection of alternatives, the panel's decision would require the very avalanche of trivia which the Supreme Court said in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976), would defeat the purpose of the proxy rules.

It is not in the public interest to put into limbo the management contracts under which mutual funds have operated for many years, to expose fund managers and directors to such huge liabilities that their ability to continue to serve is brought into question and to stimulate a new wave of derivative mutual fund litigation attacking fund proxy statements and management contracts for the past six years.

What the panel has done is to promulgate retroactively a radical change in disclosure standards which the SEC, the expert body charged by Congress with the pronouncement of disclosure standards, *rejected* in 1972. In 1969 the Commission exposed for public comment guidelines reflecting the tentative views of the Commission staff with respect to disclosure in mutual fund prospectuses (Investment Company Act Release No. 5634, Securities Act Release No. 4953, March 11, 1969). That release solicited "the views and suggestions of all interested persons before the guidelines are published in definitive form". The proposed guidelines would have required the following prospectus disclosure by mutual funds, like Chemical Fund, which decided not to pursue available recapture techniques:

"The Company's board of directors and its adviser could agree to make an arrangement with & Company to return to the Company benefits equal to the brokerage commissions & Company receives on portfolio transactions from which the investment adviser benefits. No such arrangement has been made."

This, of course, was the very disclosure which the panel held was necessary here.

More than three years later, having received "a considerable number of helpful comments" on the proposed guidelines, the Commission published definitive guidelines which rejected the disclosure proposed in 1969 for funds which had declined to pursue recapture. (Investment Company Act Release No. 7220, Securities Act Release No. 5259, June 9, 1972). The only disclosure requirement laid down with respect to recapture in the definitive guidelines is a description of recapture arrangements *if such arrangements had been made*. In that event, the suggested disclosure is:

"[The Company and & Company have made an arrangement whereby % of the net profit from brokerage commissions earned on Company transactions placed with & Company is returned to the Company by (describe the mechanism through which the Company benefits, e.g. a reduction in the advisory fee.)]"

The Commission thus rejected for prospectus purposes the very disclosure which the panel mandated for proxy statements. We see no difference, insofar as disclosure standards in this respect are concerned, between mutual fund prospectuses and mutual fund proxy materials.

We submit that the panel erred when without advertent consideration of policy implications, impact upon an important industry in which millions of people have invested their savings or the views of the agency charged by Congress with administering the Investment Company Act and pronouneing disclosure standards, it laid down a burdensome and oppressive standard which would serve no useful purpose.

II.

The proxy statement issue was not tried in the District Court and hence was not properly raised in this Court.

Plaintiff did not properly raise in the District Court any issue concerning the adequacy of Chemical Fund proxy statements and that issue was not tried.

1. The complaint did not attack the Fund's proxy statements or allege any failure of disclosure (App. 2). While a "second cause of action" alleged that the management fees paid by the Fund were excessive and that the management contracts were invalid (App. 10), that claim was abandoned in the pre-trial order (App. 27, ¶ 1; App. 38, ¶ 3(b); App. 43, ¶ 7).

2. The enumeration of plaintiff's contentions and claims for relief in the pre-trial order (App. 38, 48) made no mention of proxy statements or of any failure to make adequate disclosure.

3. In his opening statement at the trial plaintiff's counsel said:

" . . . The issue here is really a single issue, the failure of the Fund to recapture a portion of the commissions on portfolio transactions, . . ." (App., Tr. 6).

4. The only question put to any witness at the trial which was expressly directed to Fund proxy statements was a single question asked of a Fund director by plaintiff's counsel on cross-examination (App., Tr. 196-7):

"Was it ever clear in the prospectus, in the proxy statements or in any other communication to the

shareholders of the fund that give-ups were being directed prior to December 5, 1968, to brokers who did not participate in the execution?"

The answer was "no".

5. Plaintiff did not attack Fund proxy statements until it was too late to do so—in her post-trial proposed findings of fact. But even then, the only defect alleged was the failure to disclose that the Fund's brokerage practices were breaches of contract and of the Fund's certificate of incorporation and that brokers who received give-ups did not participate in the execution of portfolio transactions (¶ 43). Plaintiff also attacked on other grounds the 1972 proxy statement, but the panel held that the 1972 proxy statement was adequate.

There can be no doubt, as we pointed out in our brief on appeal in this Court (p. 48), that plaintiff's argument with respect to the Fund proxy statements was not properly raised in the District Court (p. 48). Accordingly, the issue was not properly raised on appeal and rehearing should be granted on that ground alone.

III.

Due process requires that the defendants be given the right to offer evidence on the adequacy of the proxy statements.

Since no issue with respect to the sufficiency of the proxy statements was raised before or during trial, no such issue was tried in the District Court. Due process requires that before the entry of judgment denouneing the proxy statements as false and misleading, the defendants be afforded

their constitutional right to try the issue and offer evidence in their defense.

If the issue of the adequacy of the proxy statements is remanded for trial, the defendants offer to prove the following on remand:

1. The availability of recapture was known to the SEC and its staff throughout the years in question.
2. Preliminary drafts of Fund proxy statements were filed with the SEC for staff review as required by SEC Proxy Rule 14a-6, 17 Code of Fed. Reg. § 240.14a-6. While the Commission staff on occasion required that additional disclosures be made, no one ever suggested that the availability of recapture be disclosed.
3. Most mutual funds, like Chemical Fund, rejected recapture as not in their best interests. Almost without exception, no fund which rejected recapture has ever disclosed the reasons for that decision or that recapture was available. We submit that adherence to industry disclosure practice, particularly since that practice was known to and not questioned by the SEC, is at least some evidence that disclosure was adequate.
4. The proxy statements in question were reviewed and approved before distribution to shareholders by the very directors whom the panel acknowledged to be independent and competent.
5. While ordinarily it is impossible to prove that shareholders would not have voted differently even if the disputed disclosure had been made, that is not the case here. Here, a management contract was submitted to Fund shareholders in 1970, 1971, 1972 and 1973. Defendants will prove on remand that in 1970 and 1971, years for which the panel held the proxy state-

ments to be defective, the shareholder votes approving the contracts were 95.96% and 94.3%, respectively, of those voting. On the other hand, in 1972 and 1973, years for which the panel held that the availability of recapture was *adequately disclosed*, the shareholders approved the contracts by even wider margins. The shareholder vote approving the contract in 1972 was 98.18%; in 1973, it was 98.03%.

Orderly judicial procedure requires that this and other evidence regarding the proxy statements be evaluated in the first instance by the District Court.

CONCLUSION

The question posed by this petition is of such exceptional importance that in banc consideration would be appropriate. On rehearing, the judgment of the District Court should be affirmed or, alternatively, any question of the adequacy of the Fund's proxy statements should be remanded to the District Court for trial.

Respectfully submitted,

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April 1, 1977

CERTIFICATE OF SERVICE

Service of two copies of the annexed petition for rehearing was made upon the following counsel for the parties herein by placing same in the United States mail, postage prepaid, this 1st day of April, 1977.

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